KayneCast

A Podcast Series by Kayne Anderson Rudnick

Episode 63

Market Review Third Quarter 2018

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Jordan: Good Afternoon. This is Jordan Greenhouse, Client Portfolio Manager with Kayne Anderson in Los Angeles, California. Today we're going to be hearing from Doug Foreman, Chief Investment Officer at Kayne Anderson Rudnick who will be reviewing the third quarter of 2018 market review. Doug, first and foremost thanks for setting aside the time today. Would you start by reviewing some of the key drivers during the third quarter of 2018 with us?

Doug: Well the first and most important key driver is always corporate earnings and what you saw in the second quarter was a corporate profitability was very strong, one of the strongest quarters we've had in a very long time in the U.S. Many companies did extremely well. They're benefiting from tax reform and the improved cash flow that comes from tax reform and they're benefiting from a very strong quarter. GDP ended up being slightly reported over 4% which is also very strong for the quarter. So domestically business was very very strong during the quarter. However what we saw was continued weakness in Europe and emerging weakness in emerging markets. So unlike the beginning of the year when many of the markets around the world were in sync, all growing at a pretty good rate, the U.S., Germany, Japan, emerging markets, China, etc. What we saw in the third quarter was a divergence where many of the emerging markets started to slow down, particularly China, and this has had an impact on emerging markets stock prices which have declined pretty materially during the course of the third quarter and then we also saw some weakness in Europe on the margin, not quite as strong as what we had thought so the global synchronized recovery that sort of began the year, it was a common Wall Street strategist theme at the beginning of the year. It's sort been put on hiatus and hold here obviously with a lot of divergences in economic growth around the world that we're seeing now. Primarily related to tariff and trade talk and the concerns that many businesses have that are operating abroad due to the escalation of these tariffs during the course of the third quarter.

Jordan: Thank you for that answer, Doug. And looking at the market right now there appear to be heightened tensions related to the perceived tariff wars between China and the United States. What concerns do you have related to this?

Doug: Well ironically you know, NAFTA seemed to have been resolved during the course of the third quarter. We've reached an agreement with Mexico and Canada. Some of the trade issues with the Europeans seemed to have improved a little bit during the course of the quarter including automobile tariff situation. But China definitely got worse during the course of the third quarter. We were hopeful that we could reach a resolution of these issues before the midterm elections. That seems highly unlikely, almost impossible at this point in time and probably won't reach resolution by year end. There's a lot of sticky issues and the Trump administration has basically chosen to make China the whipping child for a lot of trade issues here and so it's appearing to escalate. There's a new round of tariffs that have been imposed on 250 billion dollars worth of goods, 10% tariff that's threatening to escalate to 25% year end if an agreement isn't reached before then and this is definitely having an impact on Chinese industrial companies and Chinese exporters and Chinese economy which is having an impact obviously on emerging markets as I mentioned earlier. So continued escalation here could result in a material dislocation of business in both China and increasingly in the U.S. if this persists over a longer period of time. So I don't particularly have any insight as to when this is going to get resolved but I do believe at the end of the day that both countries recognize that a trade war between the two of us doesn't make a lot of sense for either one of us at the end of the day. So at some point I hope over the next year that these issues will be resolved.

Jordan: Coming out of 2017 there were a great deal of excitement surrounding the investment opportunities overseas for both the developed as well as the emerging markets. However, having just completed the third quarter we are seeing some continued struggles in these markets. What are your thoughts about investments in foreign markets moving forward and how are you recommending clients position their portfolios?

Doug: Well you sort of have to go around the world and look at these different markets and they're all obviously a little bit different and you know what you've seen, you know I'll cover Europe first. I think Europe is, you know, secularly challenged. There isn't a lot of great businesses in Europe overall in my opinion and there isn't a lot of technology in particular in Europe and the world is becoming more and more digital and European technology presence is really minimal in the index and in the number of companies that are globally competitive themselves. There's companies like Arm Holdings which is a good semiconductor company and SAP which is a decent software company in Germany. But really they're few and far between. So long term, you know, I think that Europe is challenged cyclically and evaluation-wise is fairly cheap today. There are not high expectations for going forward. So it has had a terrible year in terms of performance both in the stock market and economic performance really not living up to what people thought it was going to do at the beginning of the year. So long term I'm not a big fan of Europe but cyclically, short term I do think there's some opportunities in the area. I think the European bank stocks have gotten exceptionally cheap and that is an area that makes some sense to take some exposure to on a global diversified portfolio. Japan is doing better than it has in the last 30 years but still once again not a super competitive market overall on the global scene. Very homogeneous and very parochial in terms of their presence with the exception of a few large automobile companies and exporters in the Japanese economy. Japan is doing ok I would say overall. Then when you get into emerging markets there's obviously some poorly positioned countries today that are having problems like Argentina and Turkey but they're really mild and small in the grand scheme of things and not enough to really influence even emerging markets in a big way. China, however is, and China is a very large economy and China is clearly decelerating and likely to come under more pressure if these trade and tariffs concerns continues to escalate and the tariffs continue to mount. It will have an impact on China and we will see a slow down. That being said many Chinese stocks and many of the Internet companies that are in China are exceptionally well positioned long term and are very globally competitive not just in their own markets but around

the globe and so these stocks prices have come in it enough that many of them are starting to look attractive for long term investment albeit with some short term risk which are still likely to continue for a while but the prices in the stocks are starting to pay to take that risk.
Jordan: The last question I have relates to fixed income. We are noticing that the long end of the curve still does not seem to be reacting to the Fed's rate hikes. Can you talk through why this may be happening and also whether you have any concerns related to the fixed income market environment?

Doug: Well the yield curve and the shape of the yield curve is I've talked about with clients for the last couple of years has been concerning because as of a couple of weeks ago at the end of the third quarter we've had 8 short term rate increases and the 30 year bond was lower at 3% than it was 5 years ago before the Fed started raising the rates 8 times. So when people talk about interest rates going up they really need to talk about what interest rates, short term rates, medium term, long term rates. Short term rates have gone up a lot. Obviously they've gone from 0 to 2, 2 ¼ over the last couple of years when the Fed's embarked on this rate cycle hike. But the long end has not been responding to it and I think there's a few reasons for it. Number 1, you know a lot of the economic activity we're seeing today, one could argue and I don't believe it but I mean there's certainly some element of truth to it but I don't believe it wholeheartedly is that the entire improvement in corporate profitability has been driven by tax reform alone and improved cash flow. That's not really true because if you look at the companies, the revenue growth in the second quarter was very strong as well and that's not tax reform driven for the most part. So I think that the long end has been looking at longer term inflation and you had the Fed trying to get inflation up to its 2% target for well over 9 to 10 years. We finally have gotten there so now inflation is running slightly over 2% but it's still relatively well maintained. Wage growth is still relatively well maintained at a sub-3% level. With this level of employment you would expect to see wage growth in the 4% to 4.5% range. We're not seeing that and I think it's because of global competition that's still very much alive. There's still tremendous competition in a variety of industries out there and we see it every day in the U.S. and it's not going away and it hasn't gone away and I don't think it will go away. So wages have been relatively well maintained which obviously is a big component of cost. Raw material costs have gone up. Freight costs have gone up so there are some areas of strength in terms of input costs being higher than most industrial companies would like to see it. The price of steel and aluminum largely driven by tariffs. We've seen freight costs because the shortage of transportation, truck drivers, etc. has driven freight costs up for the most part. So what's happened is you've seen an increase in some areas in terms of cost but overall the long end is reacting to the fact that after lots of stimulation, years of monetary policy being extremely loose, rates at zero, you still have very very modest levels of inflation and I think that's why the long end hasn't reacted. So our principal concern has been the impossible inversion of the yield curve. The yield curve as I mentioned earlier has been flattening steadily for the last several years and now we're in a position, now what we're seeing with a couple of the data points like ISM Manufacturing came in very strong earlier in October. So since the end of the quarter the yields have risen slightly at both the 10 year and the 30 year finally has gone from the 3% range up to 3.40% which is a fairly large move in the bond market and now people are concerned with the rates being too high. I find it somewhat ironic that the whole world has sort of changed its viewpoint in 5 days. It doesn't really work like that, I don't believe but the risk of an inversion now actually seems to be receding which is causing some short term weakness in stock prices. I would argue that if you give us a choice between a possible inversion of the curve and yields being higher because of strong economic growth we'll take yields being higher because of strong economic growth every time over an inverted yield curve. It's much better for equity prices over any reasonable time period.